OECD calls on debt offices to review policy on derivatives

A new report from the Organisation for Economic Co-operation and Development (OECD) calls on debt offices to review their policy on the collateralisation and clearing of derivatives trades – a touchy subject many sovereigns have previously refused to discuss, despite consistent pressure from dealers.

"I'm surprised by this report," says the head of one European bank's sovereign, supranational and agencies (SSA) desk. "The OECD has clearly gone to a tremendous effort. It means debt offices accept there is an issue and want to understand it, and it's the first time they have indicated that publicly."

Sovereign derivatives users such as debt management offices (DMOs) tend not to collateralise their derivatives trades due to their historically bulletproof credit. However, the sovereign debt crisis has undermined that argument – *Risk* broke the news that Portugal's debt office had agreed to start posting collateral in July 2010, with the Irish DMO announcing it had followed suit at the end of June last year (*Risk* July 2010, pages 24–26, *www.risk.net/1725921*, September 2011, page 8, *www.risk.net/2099573*) – and the incoming Basel III rules also impose a heavier capital burden on uncollateralised trades. In addition, dealers have become sensitive to the funding obligations associated with contracts where they have to post collateral but don't receive any in return – a one-way credit support annex (CSA).

The 47-page OECD report, which is dated November but was first made public on December 12, makes the same points – switching to two-way agreements, or using a clearing house, could mean sovereigns don't face additional capital- and funding-related charges from their dealers, it argues. But the report also lists a series of negatives – sovereigns may not have access to enough eligible collateral or to the back-office staff and technology that enable daily margin posting, for example, and collateralisation can also affect the accounting treatment of derivatives trades (*Risk* March 2011, pages 26–28, *www.risk.net/2028466*). As a result, some sovereigns remain reluctant to change their ways.

Teppo Koivisto, head of finance at the state treasury of Finland and a member of the working group that produced the OECD report, says there have been "no changes" in his position. "We have one-way CSAs and there is no imminent pressure from our side to change our arrangements. However, we continue to follow the developments with a keen eye," he says.

Dealers and industry associations are pushing hard for change. According to a report on December 19 from the Association for Financial Markets in Europe, the International Capital Market Association and the International Swaps and Derivatives Association, one-way CSAs create significant credit risks and funding obligations. The associations estimate one-way collateral relating to European sovereigns derivatives may drain as much as $70 billion from the financial system, while dealer hedging of credit exposures through the use of single-name European sovereign credit default swaps (CDSs) could account for as much as 50% of the entire European CDS market. The adoption of two-way CSAs by sovereigns, they argue, would ameliorate these issues.

Four DMOs currently have two-way CSAs on their interest rate swaps, according to the OECD report. Those are thought to be Portugal, Ireland, Sweden – which has long had two-way CSAs in place and has gone a step further by testing a Stockholm-based OTC clearing house – and one unnamed other.

The participating DMOs also provide some aggregate numbers about the extent of their derivatives use – again, a first. At the end of 2010, the 29 debt offices that agreed to provide figures had a little over $1.4 trillion in interest rate swap notional outstanding. That's a small slice of the $442 trillion swap market – as estimated by the Bank for International Settlements in November – and might suggest the dealers are kicking up too much of a fuss.

The European bank's SSA desk head disagrees: "The issue isn't really about sovereigns, which could live without derivatives. It's about supras and agencies, as they have much larger swap books and are very reliant on the OTC market. The key is that if the sovereigns are beginning to go down this road, then it will be very hard for the supras and the agencies not to go down it as well," he says.

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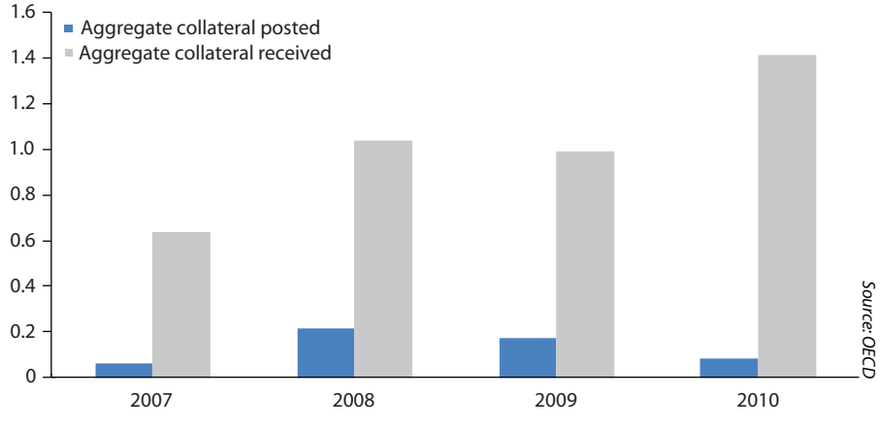
1 Aggregate collateral posted and received by sovereigns